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## Eliminate Homeowners' Rebate

Prepared for the Citizens Finance Review Commission

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1. What it is:

The homeowners' rebate, also called additional state aid, is a statutory reduction in the amount of school district primary property taxes paid by owners of owner-occupied residential property. The rate reduction each year is the lesser of the district qualifying tax rate or 35% of the school district primary property taxes. The maximum amount of the reduction is \$500. The amount of revenue not collected by school districts because of the homeowners' rebate is paid to districts by the state. (It should be noted that there are several auxiliary components of the school district primary property tax rate that are not statutorily eligible for the homeowners' rebate. Two of the largest auxiliary components though, excess utilities and desegregation expenditures, are taken into consideration when calculating the rebate amount.)

The homeowners' rebate program was initially enacted by Laws 1980, 2<sup>nd</sup> Special Session, Chapter 9. At that time the rebate was 45% of owner occupied residential school district primary property taxes. There have been several modifications to the homeowners' rebate program since its enactment. Beginning in FY 1981-1982 (Laws 1981, Chapter 291) the rebate percentage was increased to 53%. The rebate percentage was again increased, to 56%, beginning in FY 1983-1984 (Laws 1983, Chapter 62). Laws 1988, Chapter 271 established the maximum rebate amount for each parcel at \$500. Laws 1990, 3<sup>rd</sup> Special Session, Chapter 3 initiated an elimination of the homeowners' rebate program. For FY 1990-1991 this legislation established the rebate percentage at 50 instead of 56. The legislation also reduced the portion of the residential school district tax liability paid by the state by 5 percentage points each year, with the homeowners' rebate program scheduled for elimination beginning in FY 2000-2001. Laws 1994, Chapter 41 stopped the elimination of the homeowners' rebate program. Beginning FY 1994-1995, the 1994 legislation froze the rebate percentage at 35 and eliminated the remainder of the scheduled phase-out.

The proposal under consideration is the elimination of the homeowners' rebate program.

2. Administration:

The homeowners' rebate is realized through action by the county boards of supervisors. The county boards reduce the school district primary property tax rate(s) that would otherwise be levied on owner-occupied residential property by the calculated rebate amount(s). Additional state aid is apportioned by the State Department of Education to each school district to compensate for the school district primary property taxes not collected as a result of the homeowners' rebate. The additional state aid funds actually distributed to the school districts are an annual appropriation from the state general fund.

It should be noted that there is a second meaning of additional state aid. In accordance with the Arizona Constitution, the total amount of primary property taxes that may be collected from residential property each year is 1% of the limited value of the property. After calculation of the homeowners' rebate amount, the county boards of supervisors are charged with determining, for each parcel of residential property, whether the total primary property taxes to be levied will exceed the 1% constitutional cap. In situations where the cap is exceeded, a credit is applied

against the school district primary property taxes due. An amount equal to the sum of these credits for each school district is apportioned to the district in the form of additional state aid. This is to compensate for the school district primary property taxes not collected as a result of the 1% constitutional cap.

### 3. Impact on Existing Revenue Systems:

For FY 2003-2004 the total state general fund additional state aid appropriation is \$273.3 million. The estimated amount for FY 2002-2003 is \$249.8 million. This includes \$238.3 million for the homeowners' rebate program and \$11.5 million to offset the 1% constitutional cap.

Although elimination of the rebate program is a direct savings to the state general fund, eliminating the program increases the number of school districts in which the tax rates on residential property exceed the constitutional cap. In FY 2002-2003, the absence of the rebate program would have increased additional state aid associated with the constitutional cap by approximately \$39 million. Consequently, eliminating the rebate program in FY 2002-2003 would have resulted in general fund savings estimated at \$199.3 million. The elimination of the rebate increases the number of school districts at the 1% cap from the current 33 to 85. Further, the number of districts within \$1.00 of the cap increases from 20 to 48.

This is a tax increase to owners of owner-occupied residential property. The tax increase, if the rebate was eliminated in one year, would be \$142 for a \$100,000 home with a school primary tax rate of \$4.05 (the QTR for unified districts for FY 03)

### 4. Cost:

#### A. Government

The administrative cost to government of eliminating the homeowners' rebate program is insignificant. There may be some reprogramming costs at both the county and state levels for the first year of implementation. Government could also realize some annual savings because elimination of the program requires less government administration. These savings will not be large though. Because the constitutional cap remains in place, residential property tax parcels will continue to be checked to determine which taxing jurisdictions exceed the 1% threshold.

#### B. Taxpayers

There is no administrative cost to taxpayers associated with elimination of the homeowners' rebate.

#### C. Modification of Economic Activity

Theoretically, eliminating the homeowners' rebate will have some impact on economic activity. To the degree property taxes are increased, homeowners will have less disposable income. Also,

because property taxes are higher, voter willingness to support increased government spending may be diminished. The specific impact associated with these scenarios is virtually impossible to quantify.

Depending on the perspective, these effects of eliminating the homeowners' rebate may be considered a distortion or an alignment of economic activity. From the homeowners' perspective, eliminating the program changes (i.e. distorts) economic activity because disposable income is reduced. Conversely, all other taxpayers likely consider the existence of the program a distortion of economic activity because the property taxes that would otherwise be paid by homeowners are paid by all taxpayers from the state general fund. From this perspective, eliminating the program is an alignment of economic activity and rightly places the homeowner property tax burden on homeowner property taxpayers, and reduces the undue burden on all other taxpayers. (Whether this would actually result in a tax reduction commensurate with the reduced general fund cost is yet another issue.)

## 5. Policy Considerations:

### A. Equity

Eliminating the homeowners' rebate program gets mixed reviews on equity. Eliminating the program increases equity among the various classes of property taxpayers because it treats similarly situated taxpayers the same. The example is two parcels of property, one a single-family home and the other an office building, each valued at \$100,000. With the homeowners' rebate program the residential property is eligible for a tax reduction while the commercial property is not.

In the case of vertical equity, where taxes are paid increasingly with the ability to pay, eliminating the program reduces equity. Unlike commercial property, owner-occupied residential property is not income producing. Consequently, eliminating the rebate reduces equity by imposing the same tax rate (notwithstanding the differences in effective tax rates caused by the disparate assessment ratios) on property that does not have an ability to produce income as is imposed on income producing property.

### B. Economic Vitality

Theoretically, eliminating the homeowners' rebate program increases economic vitality. Theoretically, eliminating the program returns the undue property tax burden borne by all other taxpayers back to owner-occupied residential property. This is a "tax relief" for all other taxpayers and should have some (albeit small) positive impact on business investment.

### C. Volatility

There is really no impact on the volatility of the tax structure by eliminating the homeowners' rebate. As a revenue source, the property tax is noted for stability. With the exception of increasing the number of 1% cap districts, changing this feature of the current property tax

system should not compromise or improve that stability. Increasing the number of 1% cap districts could provide a disincentive for the effected local governments to control increases in primary tax rates.

#### D. Simplicity

Although eliminating the homeowners' rebate does not significantly improve simplicity of the property tax system, it does make the overall tax structure more direct and transparent by transferring the cost of the rebate from all taxpayers back to those who have been benefiting from the program.

#### 6. Economic Impact:

Although this change does result in a tax increase to owners of residential property, the increase is not likely to manifest in a measurable decrease in economic activity on the part of homeowners or individuals in the market for a new home.

#### 7. Other:

##### A. Low Income Homeowners Income Tax Credit

The proposal to eliminate the homeowners' rebate program includes possible consideration of a temporary income tax credit to alleviate the additional property tax burden on low-income homeowners. Although it would be somewhat complicated to craft the specific parameters of the income tax credit (income definition, income threshold, refundable, double deduction), once crafted, the credit could be implemented relatively simply and with little administrative cost to government or taxpayers. The Department of Revenue Office of Economic Research and Analysis has an income tax model capable of estimating the revenue impact of this type of credit. This makes it possible to design the credit parameters to meet an acceptable revenue impact.

It should be noted that after two years 15% of the revenue impact associated with a new income tax credit would be borne by cities and towns through reduced urban revenue sharing. This lowers the cost of the credit to the state general fund. Alternatively, the urban revenue sharing distribution could be adjusted to mitigate the loss the cities and towns.

##### B. Proposition 108

Proposition 108 (enacted by the voters in 1992) is a constitutional provision requiring a two-thirds vote of each house of the Legislature for passage of a measure "that provides for a net increase in state revenues" that takes one of eight specified forms. In instances where the provision is applicable, the legislative measure includes a separate Prop 108 clause that specifies the requirement for enactment.

The issue of whether elimination of the homeowners' rebate program requires a Prop 108 clause is debatable. Although one of the eight specified forms, "a reduction or elimination of a tax

deduction, exemption, exclusion, credit or other tax exemption feature in computing tax liability,” seems to encompass the homeowners’ rebate, it is arguable whether elimination of the program “provides for a net increase in state revenues.” In fact, elimination of the rebate is a reduction in state expenditures and *not* an increase in state revenues. Based on this analysis, eliminating the homeowners’ rebate is not subject to Prop 108 requirements.

### C. Politics

One theory is that the homeowners’ rebate exists as a gesture from state legislators to their constituents to curry favor: people (i.e. homeowners) vote but businesses do not. In accordance with this theory, eliminating the program may be seen as a sign that legislator interest in their constituents is waning.

On the other end of the spectrum, relatively few homeowners pay careful attention to their property tax bills and many are not even aware that the rebate program exists. This is because the property tax bill is relatively confusing. Also, because most pay property taxes with monthly mortgage payments, few people go through the pain of writing a separate property tax check. The result is that this tax benefit, intended as voter goodwill, may be going largely unappreciated.

Although a drastic property tax increase of \$500 at one time may heighten taxpayer attention, because property tax bills change somewhat every year, a phase-out of the program may get little notice.